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TAGS: ECON EINV ETRD EFIN SR
SUBJECT: SERBIA: GOVERNMENT STRUGGLES TO CLOSE THE BUDGET GAP

Ref: A) Belgrade 272   B) Belgrade 210

SUMMARY

¶1. (SBU) The Serbian government revised downward the budget to reflect the stark economic contraction and the requirements of the IMF to move ahead with an expanded $4 billion program. At its April 16 session the government adopted a rebalanced 2009 budget which included deep expenditure cuts in an effort to keep the 2009 budget deficit at 3% of GDP. The revised package has more public support than the government's bungled initial proposal to increase income taxes on all but the poorest Serbians by 6% and business leaders and economists told us the plan was a significant improvement. The new plan's critics include mobile phone operators and mayors. If passed through parliament and implemented the government's plan will maintain macroeconomic stability in the short-term, but questions remain about the economic situation later in the year. End Summary.

Let's Try This Again

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¶2. (U) On April 8, just two weeks after the Serbian government announced a package of budget measures as part of the agreement on a revised IMF Stand-By Arrangement (ref A), Prime Minister Cvetkovic presented a new package to meet the IMF requirement to close $1.5 billion of the 2009 budget gap. The revised budget deficit was projected at $1 billion or 40% higher than originally planned, but within the 3% of GDP limit the IMF imposed. The government formally adopted the package at its April 16 session and sent it to parliament. Parliament speaker Slavica Djukic-Dejanovic announced that Parliament will take up the package starting April 24.

Solidarity Tax Proposal - Oops

¶3. (SBU) The government's initial proposal to close the majority of the budget gap with a six percent "solidarity tax" on nearly all Serbs' income was rejected by the public with such fervor that within 24 hours the government backed away from the announcement. The government has publicly and privately tried to point the finger at the IMF for pushing the solidarity tax idea. Deputy PM Dinkic told us on April 9 that the IMF team introduced the solidarity tax proposal. President Tadic similarly pointed the finger at the IMF in a wide ranging interview in weekly magazine Vreme on April 16.

Government Credibility Suffers

¶4. (SBU) Business leaders and economists told us that the government's bungling of this announcement severely undercut the credibility of the economic team. This reinforced public cynicism about Serbian leadership and squandered the opportunity to build momentum for long stalled reforms.

¶5. (SBU) Despite having held several orchestrated public dialogue sessions with businesses and labor leaders the government appears to have failed at the basic business principle of listening to its customers. Recent International Republican Institute polling indicated that more than half of Serbs gave the government a D or an F for handling the economic crisis. The Serbian public did not blame the government for the crisis, but as the head of the Serbian Association of Managers pointed out, while in the U.S. banks were the focus of public outrage, in Serbia the public's ire was directed toward the inefficient and bloated government bureaucracy.

Cut Spending by $1.3 Billion

¶6. (U) The revised plan significantly shifts the burden of closing the gap from government revenues to government expenditures. PM Cvetkovic said the package was the largest fiscal adjustment ever.

The bulk (85%) of the fiscal adjustment would come through aggressive cuts in expenditures ($1.3 billion), while only 15% would be met through increases in revenues ($230 million). The plan would cut each ministry's budget by 26% ($571 million); cut expenses of all institutions which collect their own revenues, i.e. universities, ($171 million); cut transfers to municipalities by one third ($214 million); and cut in costs at public companies and the Health Fund ($129 million).

¶7. (U) The revised package would also freeze public sector salaries and pensions ($186 million). The government also plans to cut salaries for high wage public sector workers by 10% or 15% depending on their wages ($29 million). The workers affected by these cuts would be limited as those in education, health, culture, the army and the judiciary would all be exempt from the cuts (but not the

freeze). However, public support for this measure is high because it is perceived at attacking a fundamental reform issue, namely that public sector wages outstrip private sector wages.

¶8. (U) Cvetkovic also announced that the government would begin cuts in overall number of public sector employees with a goal of reducing the public sector wage roles by 8,000 people (10%) in the next 9 months. Cuts would also be necessary in local government, with severe cuts in transfers to municipalities. These cuts, if they are carried out, would only lead to savings in future years as a result of severance costs. More importantly, current employment laws must change to allow for reductions in government jobs, as the current laws and procedures make it nearly impossible to layoff or fire public sector employees.

Increase Revenues by $230 Million

¶9. (U) The revised budget cuts revenue projections by 7.1% to $9.28 billion. The new budget projected revenue decreases are based on a drop in VAT collection of 11% below the original budget, a corporate profit tax revenue drop of 21%, and a 16% fall in customs revenues. The government package includes revenue increases through hikes in excise taxes on fuel ($72 million); introduction of a 10% surcharge on cell phone bills ($43 million); increases in property taxes for large houses and luxury vehicles ($43 million); and a surcharge on capital gains income ($72 million).

Anyone Willing to Give us a Loan?

¶10. (SBU) Spending cuts and limited revenue increases leave the Serbian government with a $1.3 billion deficit. The government plans to cover this gap with a combination of measures. Deputy PM Dinkic told us on April 9 that the government planned to seek $650 million in loans from commercial banks, mostly in foreign currency. In addition, Deputy PM Djelic has lobbied Brussels to allow Serbia to use $160 million of the EU's IPA program assistance in 2009 on budget support. The Treasury also plans to issue additional short-term treasury bills. Dinkic told us, and Finance Minister Dragutinovic told daily Politika on April 18, that Serbia will also

pursue a loan from Russia. The government is also seeking tied aid projects, focusing on a proposed Chinese deal to construct a $200 million bridge as part of the Belgrade ring road.

Some Stimulus Measures

¶11. (U) While spending cuts and taxes were the headlines in the budget package, the proposal did add to some existing measures to support infrastructure investment and support business liquidity. The package increased capital to subsidize the interest rates on banks loans to businesses from $1.74 billion to $2.31 billion, provided $29 million for business start-up loans and added $214 million for loans to SMEs. Dinkic also reaffirmed the government's commitment to conclude $1.3 billion in loans from IFIs and bilateral credits for road construction along Corridor 10.

Possible Additional Measures

¶12. (SBU) Dinkic also proposed several measures to deal with public and private sector debt. The heads of Societe Generale and Hypo Bank complained to us that the government is behind in making payments to private companies for purchases, and VAT refunds, adding to liquidity problems in private firms. The government hoped to use a new commercial credit line from Societe Generale to address catch up on these payments. At the same time, many firms have outstanding debts to public utilities (gas and electric power). Dinkic has suggested publicly and privately to us that recently privatized firms could trade equity to the government as payment for these debts. Dinkic has also promoted measures to increase cooperation among banks and companies to examine debt linkages where a liquidity crunch at one firm leads to cash flow and payment problems in a series of other firms. These efforts on linked debt and debt-equity swaps are still just proposals and have not attracted additional champions in the government.

¶13. (U) The debt problem is exacerbated by the primitive state of bankruptcy procedures here in Serbia which leads debt holders to race to put holds on accounts of firms with overdue debts, locking up liquidity to help solve the problem. Of the over 380,000 registered companies in Serbia (many of which are just shell companies) more than 60,000 have accounts blocked. As a result, many businesses are forced to operate on a cash basis, further contracting government tax revenues.

Experts: Measures Good if Implemented

¶14. (SBU) The Prime Minister established a council of economic advisors to provide advice and support during the crisis, but the group has met only once since January. Unfortunately, Cvetkovic only consulted with the group of prominent economists about the budget package after he finalized the details. Economists and business leaders that we spoke with said that the amended government package was much better than the initial solidarity tax proposal. However, many said that the government was still playing catch up with the deteriorating economy. Economists, including Vladimir Gligorov from the Vienna Institute and Mihailo Crnobrnja, former Yugoslav Ambassador to the EU and professor at the private Faculty of Economics, Finance and Administration, commented that the government based its budget projection on a now optimistic projection of a 2% drop in GDP. Gligorov told us that a 5-6% GDP fall was more realistic and that he had concerns about the government's ability to follow through on expenditure cuts.

Resistance: Mayors

¶15. (U) The mayors association held a press conference on April 7 to protest the package's cut in transfers to municipalities. Leading mayors, including Mayor Jesic from the business friendly municipality of Indjija, said that the cuts would lead to collapse in municipalities some could face bankruptcy. So far local leaders'

concerns have not slowed the progress of the package through government.

Businesses Say They Want to Help

¶16. (SBU) Business leaders, including the heads of two major banks and the head of the Serbian Association of Managers told Dinkic and the Prime Minister's Chief of Staff at an event hosted by the Ambassador April 9 that companies wanted to work with the government to build support for crisis measures. The leaders said they wanted to support the government publicly, but pleaded for more consultation and the opportunity to provide suggestions on new measures. One business person suggested that the government needed a "situation room" to coordinate actions and messages, and to show the public the actions it is taking to address the crisis.

¶17. (SBU) While President Tadic and PM Cvetkovic have held several formal and informal meetings with businesses and labor groups, the government leadership is still not comfortable building allies and support with business. The government's concern for building relationships with businesses has been tempered by a fear of becoming politically linked with unpopular Serbian "tycoons," who are thought to wield significant political influence behind closed doors.

COMMENT

¶18. (SBU) The government's already limited credibility took a big hit with the aborted solidarity tax proposal. The new package focuses the pain on the easily vilified government bureaucracy and has thus received little criticism. Even labor unions, which are concerned about the planned cuts in public sector jobs, have been unable to organize demonstrations or a campaign against the package. The political opposition has not advanced any economic alternative.

¶19. (SBU) The government's new budget package will be painful, if fully implemented. It is difficult to believe that the deep cuts in expenses across the public sector will result in as much saving as the budget projects. The Finance Ministry will need a strong hand to stand up to the political demand from ministers for resources. With the additional IMF resources, and the commitment from international banks in Serbia to keep capital in the market, Serbia can limp through to the fall. The real crunch time will be the when Belgraders return from summer vacation to a still bleak economic outlook. Regardless, the government has recovered some momentum and will need to press ahead with the difficult spending cuts needed to stabilize the macroeconomic situation, while advancing the reforms that can support new business activity once the global economy begins to recover.
End Comment.

PEDERSON